



19 November 2003

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Dear Nienke

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW: OCTOBER
2003 UPDATE (INCLUDING CEPA PAPER ON BENCHMARKING)**

We are pleased to provide our comments on the above document on behalf of EDF Energy's three distribution licensees: EPN, LPN, and SPN, covering the areas of East Anglia, London, and South East England.

A detailed commentary by NERA on CEPA's benchmarking paper is attached. EDF Energy fully endorses and concurs with the views expressed by NERA.

Our full and detailed comments are set out in the attachment to this letter. They can be summarised as follows:

- Efficiency incentives should be based on ex-post "discovery" of savings (except for long-term TFP growth) rather than on the ex-ante anticipation and capture of such savings by Ofgem.
- Ofgem should introduce enforceable mechanisms to address uncertainty between price control reviews.
- Ofgem should clarify whether and, if so, how it intends to assess whether a company is allowed to retain the benefit of capex efficiencies, in a way that minimises regulatory discretion – as this undermines incentives.
- The exemplified calculation of the rolling opex mechanism is welcome: we suggest a number of further detailed clarifications.
- Ofgem should set targets by reference to average rather than frontier performance, so that averagely efficient companies earn the average rate of return, and more efficient companies will then prosper automatically through higher returns, as happens in the rest of the economy.
- Ofgem's approach to comparing quality of supply is not robust and cannot provide a basis for target setting in its current form.

- Any attempt by Ofgem to assert that deviations from frontier performance in quality of supply are the result of “inefficiency” will be unacceptable.
- We suggest that Ofgem focuses development of quality of supply incentives on worst-served customers.
- We cannot conceive of a fair and robust resilience incentive scheme that is based on outputs – in this case, a focus on inputs may be necessary.
- We consider CEPA’s description of the DPCR3 benchmarking as “robust” to be wholly inconsistent with CEPA’s own findings.
- The use of the RAB to define capital costs is indefensible because the RAB is distorted by past regulatory decisions and historical accidents.
- Use of a combination of benchmarking approaches (each of which is to a greater or lesser degree flawed) will not produce a robust result without extensive discussion with companies about their meaning.
- We should be allowed to retain the benefits arising from the integration of SPN in line with commitments given in Ofgem’s correspondence with us at the time of acquisition.
- Current price controls were not based on efficient accounting charges, but on the standardised controllable costs of one company – Eastern. However, we would suggest that it is impractical to delve into past price control allowances to elicit the “assumed” pension cost element.
- Only pension deficits attributable to current non-distribution staff should be excluded from the amount recoverable from distributors.
- Ofgem’s argument that company shareholders have benefited from past outperformance ignores Ofgem’s practice of setting cost frontiers and catch-up targets – from which shareholders have derived no benefit at all. Customers should pay for the cost of achieving such savings.
- We support the development of a full regulatory impact assessment for distributed generation.

We confirm that all of this response and the attached paper from NERA can be published on Ofgem’s website. However, we have written separately and confidentially about registered power zones.

Yours sincerely

Paul Delamare

Head of Price Control Review

Attachment:

EDF Energy's detailed views

Form, structure, and scope of price controls

We agree that incentive regulation, in the form of RPI-X price controls, has delivered reduced costs, continued investment, and quality improvements. However:

- Cost efficiency incentives should be based on the ex-post “discovery” of savings (including those arising from mergers – see below) rather than on ex-ante anticipation and capture of such savings by Ofgem. (We recognise that such capture was a feature of the last price review, but it is not a desirable feature of regulation as it reduces out-performance rewards and hence incentives. We do not believe that Ofgem has advanced a robust rationale for continuing with this policy.)
- The use of cost frontiers can inappropriately transfer cost reductions (as opposed to efficiency improvements) to other companies (for example, via reduced pension contributions).

Pass-through costs

While it is technically true to say that distributors can exert some influence over the cost of NGC exit charges and rates, the degree of such control is minimal, and in our view is not sufficient to warrant separate incentive arrangements, particularly given the corresponding (relatively large) risk of forecasting error. Also:

- Rates costs are a function of substation capacity (MVA), which is mostly fixed by underlying demand patterns, although some adjustments at the margin can be achieved (for example, by decommissioning underused transformers). Of course, any saving in rates represents the avoidance of a transfer (which local authorities will make up from other sources) rather than a real cost saving. Forecasting rates will be complicated by the uncertain impact of distributed generation.
- Exit charges are a function of the number and cost of NGC/distributor interfaces, which are largely historical and cannot be changed in the short term. Again, should new capacity be required, or redundant assets be removed, distributors can only impact exit charges at the margin, with a minimal effect on costs. Avoiding the use of existing assets will not avoid costs, because NGC levies a “termination charge” to ensure that it can recover all outstanding costs of the investment.
- The forecasting of exit charges is currently complicated by the prospect of a number of large redevelopment schemes which may or may not require additional or modified grid connections, and also by possible changes to NGC's charging methodology (of which Ofgem is aware).

Given the current treatment of business rates as non-pass-through cost items, we welcome Ofgem's commitment to adjust price control revenues for any material differences between forecast and actual amounts. We also note that the current arrangements for charging rates on meters are under review. Clearly, the price control arrangements will need to reflect the outcome of this debate.

We are disappointed that Ofgem has not built on the work undertaken by Frontier Economics and its own working group on dealing with uncertainty. While we do not agree with a number of the assumptions in the approach developed by FE, we believe that it formed a reasonable basis for informed discussion between Ofgem and the industry and would have provided a mechanism for assessing pass-through cost issues. The uncertainties that could be the subject of such a mechanism include:

- Any extension to lane-rental charging or any other (for distributors) costly changes to streetworks legislation
- Supplier bad debt
- New environmental or safety related obligations
- New requirements for increased network resilience and readiness for civil contingencies

It is our opinion that, for risks of this nature and of such potentially large impact to be mitigated, Ofgem must establish a formal mechanism which allows distributors to recover any material, efficiently incurred, unforeseen costs.

Fixed retention periods for efficiency savings

Ofgem intends to take a "general view of companies' compliance with security and quality of supply obligations in determining whether to allow the retention of capex efficiencies" arising in the current period.

Ofgem should set out how it intends to make such "general" assessments in a robust and fair way. In particular, we would oppose any arbitrary adjustments of the type seen in the last price review – the so-called "within range adjustments". These are not a feature of good regulation. Instead, Ofgem should focus on finding a robust and transparent method of setting revenues which reflects the individual circumstances of distributors.

Rolling opex adjustment

The exemplified calculation shown at paragraph 3.18 is useful and welcome. We would suggest the following additional elements (some of which are based on Ofwat's new proposals for PR04, set out in MD187):

- As proposed by Ofwat, atypical and exceptional costs (arising from a storm, for example, or from new taxes) should be excluded.
- Ofgem should clarify how the scheme is made neutral to inflation.

- To avoid the need to correct revenues in the next but one review period, Ofgem should adopt Ofwat's proposal to extend the benefit period to six years – which would make such an adjustment unnecessary and would strengthen incentives.
- The mechanism for carrying forward the rewards into subsequent price control periods should be included in a licence condition so that they are unambiguous and certain. The amounts in question should be included within regulatory accounts (like the carry-forward of RAB additions)

Ofwat is also proposing that enhanced incentives should be provided to frontier performing companies through the use of a multiplier (e.g. X 1.5 or X 1.25). We believe that such an approach could only be contemplated in respect of electricity distribution when regulatory information is provided by all distributors on a fully comparable basis. However, we do not expect such a position to arise until well into the next price control period as it is clear that much further work is required to refine the regulatory accounting and information framework.

Ofgem set opex targets at the last review based on frontier cost levels despite only allowing an average low-risk rate of return, which is a worse return than that offered by the average stock market company (which, by definition, achieves only average performance). Ideally, to avoid this inconsistency, Ofgem should allow all companies a frontier rate of return. However, because of the difficulties in establishing frontier rates of return, Ofgem should instead set cost allowances on the basis of average costs. This would have the added advantage of mimicking the operation of competitive markets.

Ofgem's proposal that opex overspends will be constrained not to be negative for the period 2005–10 is welcome. It would be helpful if Ofgem could declare its intentions regarding future periods.

Rolling capex adjustment

Although Ofgem has included a mechanism within its draft financial model, it would be useful to see a worked example and further clarification set out in a consultation document. This would enable a clear understanding of:

- The definition of the relevant allowances and spend
- The treatment of inflation
- The treatment of incremental cost increases
- The treatment of overspends against allowances
- Any links with other performance obligations
- Any adjustments for subsequent review periods
- Regulatory accounting treatment
- The impact of any cost drivers (or other flexibility mechanism) for adjusting the target as circumstances change.

Treatment of distribution losses

Progress in this area seems to be slow and it is disappointing that we will not see the value of the proposed incentives until June 2004, since it prevents us from adopting an efficient planning response to the incentives on offer.

Given that losses improvements are not a feature of Ofgem's Forecast BPQ planning assumptions, we assume that any improvements will need to be funded out of incentive rewards (net of any capex incentives forgone). If the incentive does not support the associated marginal investment, the effect of Ofgem's revised arrangements would be simply to introduce more risk (mainly associated with data quality, which is outside distributors' control). For this reason, it is essential that Ofgem carries out a separate cost-benefit review of its proposals.

The lack of any costs associated with the reduction of losses in our opex and capex forecasts means that Ofgem should not set targets for performance improvements in this area without making appropriate allowances for the cost of achieving these.

Consumer survey

We welcome the publication of the first stage survey results. We have always maintained that, if Ofgem is to properly protect consumers' interests, it must first find out their views.

The first stage results provide no support for increased quality standards or higher compensation values. They indicate that:

- Even in a sample, biased towards customers who had been recently interrupted, customer satisfaction levels are high.
- Customers find additional quality of supply measures appealing, but are unwilling to pay for them.
- Customers expect outages during severe storms, but also expect good communication at such times.
- Compensation for outages was generally seen as secondary to quick restoration and good customer service.

The study recognises that it provides no useful evidence on willingness to pay, but leaves open the question of how the intrinsic problems of identifying customer preference in this area are going to be addressed in the next stage of the work. Clearly, the second stage work will need to be based on robust choice modelling.

We also comment below on Ofgem’s approach to comparing quality of supply performance. In the context of willingness to pay, it is unfortunate that Ofgem has set out indicative targets which, in many cases, could only be achieved at very substantial cost – and which customers are unlikely to be willing to fund. A better way of phrasing the question would have been to ask each distributor to indicate the quality improvements that it could deliver for (say) £1, £2, and £5 (per customer per year). Such an approach would align well with questions posed as part of the second stage willingness to pay work. We believe that this is a missed opportunity.

Compensation to business customers

The survey indicated that business customers want considerably more compensation, but the survey offers no guidance as to whether they are willing to pay more for this service.

Compensation is currently available to business customers by procuring business interruption insurance. It would not be appropriate for distributors to provide an alternative insurance arrangement through the guaranteed standards mechanism since this would undermine the market for such cover and could imply a cross-subsidy between customers.

Comparing quality of supply performance

We believe that it is appropriate for Ofgem to look at establishing long term quality of supply targets. Incentives to invest in quality improvements weaken towards the end of a price control period, since it is unclear what targets companies will be required to meet in the next period. Short term quality of supply targets may therefore lead to inefficient investment in the long term.

However, we must disagree strongly if Ofgem believes that it has created a robust method for comparing quality of supply performance between distributors and for setting targets on that basis. It has not.

We would be even more concerned if Ofgem were to attempt to assert that any differences in performance are the result of “inefficiency”, and can be addressed without funding. Such an approach would not be acceptable.

Ofgem’s work in disaggregating and re-aggregating quality of supply information has some value as a starting point for investigating the complex reasons why one network may perform better than another. However, the complete lack of any explanatory “proof” of Ofgem’s adjustments means that this work cannot be used to set targets directly or to make any robust published statements about relative inter-company performance.

Performance improvement targets must be based on objective information about what is feasible (i.e. in practice starting from current levels) and must be set to ensure that feasible rates of improvement are linked to increases in cost that consumers are willing to pay.

Ofgem's estimated half percent year on year improvement appears to be a wholly arbitrary assumption which, over the period 2005–2020, amounts to an additional improvement of around 10 per cent. Such an assumption has the potential to double-count any assumed TFP growth (which will already have accounted for a growth in output efficiency).

We also believe that Ofgem's 2005–2020 glide path is unrealistic in situations where the level of improvement suggested would require significant investment in network rebuild or reconfiguration. In these circumstances, quality of supply performance is likely to deteriorate in the early years, improving only as soon as the bulk of the work is complete. Conversely, achievement of any 2010 targets would imply no such rebuild or reconfiguration, and hence would lead to a flat performance path – as all the practicable improvements are used up.

In paragraph 4.27, Ofgem states that frontier performers, with respect to customer interruptions and customer minutes lost performance, will be rewarded. It is difficult to see how Ofgem can contemplate quality frontiers without any proof of its comparison calculations.

Quality of supply: proposed way forward

CI and CML targets focus on average performance, and as such will encourage distributors to focus on circuits with the highest number of customers attached. These are likely to be urban circuits. However, this approach ignores the spread (i.e. the degree of deviation from the average). Ofgem's approach is (typically) therefore unlikely to improve the performance of circuits in sparsely populated rural areas – and yet these are likely to be among the worst performers.

Instead of focusing on quality of supply generally, we propose that Ofgem should concentrate on incentives for addressing worst served customers. It would seem feasible to devise an incentive scheme that focuses on, say, circuits with greater than n standard deviations below the mean performance.

Scope of output measures/network resilience

We have no objections to incentives for resilience in principle, but there would seem to be many practical difficulties.

We appreciate that an incentive based on outputs (i.e. a distributor's restoration of supply performance during and after adverse weather) is attractive from a regulatory viewpoint. However, we believe that this would be impractical to implement, as it is not possible to predict the impact of any particular event and so predetermine what might be an efficient response. Therefore, any such

incentive is likely to be arbitrary and potentially unfair in its effect, so that it effectively offers no reward for efficient preparations. For example:

- Trees in leaf / not in leaf
- Soil saturated / not saturated
- Ground soft / ground frozen
- No snow / deep snow
- Short event (storm) / long event (extended period of snowfall)
- Prevailing wind direction / unusual wind direction
- Localised / dispersed
- Conditions safe / conditions not safe

Consequently, any such incentive is likely to be arbitrary and potentially unfair in its effects.

We would also be very concerned if Ofgem were to implement a comparative incentive mechanism for network resilience. Such an approach could introduce a perverse incentive for companies not to share resources during exceptional events. This would clearly not be in customers' best interests.

A resilience incentive could, however, be based on the achievement of key input standards, such as the following examples:

- Vegetation management: companies could be rewarded for achieving pre-defined vegetation management standards.
- Relevant investment: companies could be incentivised to invest in measures to improve resilience through the achievement of higher rates of return.
- Storm preparation: contingency plans could be published and be made subject to regulatory/DTI scrutiny.
- Improved communications/information technology: suitable funding could be provided through allowance for non-operational capex.

More generally, it is clear that enhanced investment levels will provide distributors (subject to any skills shortages) with a larger pool of available employees to deal with the effects of severe storms, whereas reduced investment in response to price control restraints (for example) will have the opposite affect – as will any significant loss of connections business market share.

We understand, and broadly support, Ofgem's reluctance to incentivise inputs. However, network resilience seems to be an area where an output based scheme is both impracticable and undesirable.

Distributed generation

Volume and costs of distributed generation: Views were invited on a number of specific issues raised in this paper. The first is the summary information on the volume and costs of distributed generation that is shown in Table 5.1. EDF Energy's view is that this table demonstrates the broad range of costs that could arise from the connection of DG and therefore the associated level of uncertainty. There is a wide range of possible amounts of DG that may in the event need to be connected, and a lack of clarity about both the technologies that will emerge as successful and the costs of connection.

Incentive framework: While we broadly support the proposed incentive framework for DG, this needs to be soundly based on the legal and regulatory structure for connection (for example, there needs to be consistency with the power to recover connection costs set out in the Electricity Act). Assuming that this can be done, the level of cost uncertainty illustrated in Table 5.1 suggests that a large proportion of costs needs to be passed through for the overall scheme to be consistent with the distributor risk profile. There may be a limited role for a suitable (£ per MW) incentive rate which provides an appropriate and appreciable incentive to the distributor to seek out and facilitate DG.

Many issues will need to be addressed in order to introduce arrangements to incentivise provision of network access on an ongoing basis. In particular, there will need to be clarity about the connections to which this would be applied and also about those selecting lower cost connection arrangements, for whom the arrangements would not be available. Many existing generators have selected low cost connections and it may be that all such generators would need to be omitted from the scheme. The arrangements will need to be designed to avoid perverse incentives emerging for the distributor.

Ofgem will also need to provide distributors with some assurance that they will be able to earn an adequate rate of return throughout the life of the investment (for example, by setting down accounting standards that clearly record the costs to be recovered in the future, or by maintaining the £ per MW top-up for at least the regulatory depreciation life of the asset).

The issue of incentivising secure network access may need further consideration. Currently, most generators connected at HV and LV are connected on radial networks. So, in the event of network maintenance or a fault, they will not be able to generate – but would not be eligible for any rebate for loss of access.

Innovation funding initiative: We argued in our response to the innovation and registered power zone paper that many of the most innovative developments arise from three inter-related elements:

- **Business need:** a clear business need on the part of the distributor which seeds an embryonic idea.

- **University and research input:** developing a robust scientific understanding of the physical mechanisms and processes involved.
- **Technology:** turning a concept or prototype into a viable product.

There is often a need to understand how fundamental processes actually work in real systems before being in a position to fully develop an embryonic idea into innovative developments and/or better products.

We stressed that it was not clear that Ofgem's model of the innovation process fully reflected such an approach to the creation of fundamental new technologies. We suggested that this could be mitigated by ensuring a broad interpretation of the types of activity defined as Category B projects. However, a complementary approach would also be to extend the funding initiative to Category C activities and we would support this as it would more clearly relate to the early stages of projects as outlined. Benefits would include the encouragement to distributors to get actively involved not only as sponsors but as key partners in such activity and to accept the inevitably higher risk involved. This approach would also encourage the innovation and development activities of manufacturers, who are likely to see the early involvement of distributors as reducing their own risks

Incentives for demand connections

Ofgem believes that it is worth considering applying the mechanisms developed for DG to demand connections. However, given the current high levels of uncertainty about the impact of Ofgem's structure of charges proposals on the boundary between connection and use of system charges, we would suggest that now is not the time to attempt to calculate £ per MW cost drivers in respect of demand connections.

Registered power zones

We are continuing to explore opportunities for registered power zones. However, our ideas are at the conceptual stage at present and should be regarded as confidential to Ofgem. They are therefore being provided under separate cover.

CEPA's study on benchmarking

We asked National Economic Research Associates (NERA) to provide a detailed commentary on the benchmarking report by Cambridge Economic Policy Associates. NERA's critique, the conclusions of which are fully endorsed and supported by EDF Energy, is attached to this response.

In summary, it is clear to us that the CEPA study adopts an ambivalent view of benchmarking, at some points regarding it as a robust method which produces clear indications of efficiency or potential cost reductions, and at other points undermining such claims by pointing out the deficiencies of the analysis. The following points are particularly relevant:

- **DPCR3 approach:** CEPA tries to apply the methodology used in DPCR3 to data from 2001/02, but the results suggest that this is not worthy of repeated use. It also appears that CEPA thinks that Ofgem's 1999 method was robust only because it did not rely entirely on the numerical analysis (or, indeed, on any particular analysis) and instead allowed for the exercise of regulatory discretion. This is a most unorthodox use of the term "robust", as it clearly has little to do with the transparency, stability, or predictability of results.
- **Use of "totex":** The use of the RAB to define capital costs is indefensible. The RAB is distorted by past regulatory decisions and historical accidents. Although the pre-privatisation assets are starting to drop out of companies' RABs, most of those assets are still in use. Moreover, pre-privatisation investment affected subsequent investment needs, and hence the current value of the RAB. Thus, the RAB offers little guidance on the efficiency with which each distributor is using its resources, or has invested capital since privatisation. We would expect any attempt to assess efficiency to use a measure of total assets employed by the company: i.e. either a registry of assets (for DEA or TFP) or an estimate of replacement costs that applies common valuation principles to all assets.
- **Choice of approach:** Ultimately, CEPA comes down in favour of Ofgem using a combination of DEA to benchmark companies and COLS (i.e. regression) to check the validity of the choice of variables. However, CEPA also warns against using any single method to set X factors or costs in a mechanistic way, because of the difficulties of applying any method. This conclusion is unhelpful, since Ofgem is left with the option of having to fund many benchmarking exercises, each of little or no value, while distributors are left not knowing how their performance will be appraised or how revenues will be set. CEPA refers to Dutch experience in this context, but many of the caveats that CEPA expresses about particular techniques of benchmarking undermine its advocacy of benchmarking in general.
- **Inclusion of quality parameters:** Any attempt to include quality of supply parameters in a benchmarking exercise would face a number of problems, including identifying the influence of inherent and inherited factors (which are not under the control of management) on quality levels. As a result, quality differences remain another consideration (apart from efficiency) that may explain differences in benchmarking scores.
- **The use of international data:** In regulatory benchmarking, the use of international data frequently poses more problems than it can solve. The main issue is that of comparability, especially since countries differ not only in the unbundling, cost allocation, depreciation, and taxation principles that are used at the distribution level (leading to generic cost bases which are not comparable across national borders), but also in the exogenous cost factors faced by companies.

- **Way forward for Ofgem:** In the light of CEPA's report, while Ofgem may still feel obliged to carry out some benchmarking, it should not use any particular results without extensive public discussion of their meaning, and should look at other methods of identifying expected cost levels. Our own preferred methods are to focus on individual and comparable expenditures as a way of checking capex, and to use long-term TFP trends to set trend rates of growth in unit costs.

Assessing costs

Ofgem's commitment not to combine different approaches to efficiency assessment in an arbitrary and predetermined manner is welcome, although it is weakened by Ofgem's perceived need to "apply a degree of pragmatism".

Ofgem's commitment to use the results of the TFP research is also welcome in the context of the need to estimate a plausible average or reasonable future growth rate in productivity. However, the inclusion of short-term non-repeatable effects (including privatisation) will produce biased estimates of future potential that cannot be sustained. Ofgem should therefore ensure that CEPA's work looks at steady state progress or long-term growth rates (in this country).

Treatment of mergers

EDF Energy has legitimate expectations about the benefits arising from London Electricity's acquisition of EPN (from 2002, though most savings were associated with the 24Seven deal which commenced in April 2000), and the subsequent purchase of SPN (July 2002).

In particular, we would expect Ofgem not to include any forecast merger savings arising from the SPN acquisition in the 2005–2010 price control. Any premature capture of such savings would destroy incentives and would not be consistent with Ofgem's stated policy.

This was clearly acknowledged in Ofgem's correspondence with EDF Energy in September 2002, in which Ofgem stated that:

"It will be important to ensure both that companies continue to face incentives to improve efficiency in the future and that they are appropriately rewarded for having done so in the past".

In the same correspondence, Ofgem also stated that merger savings could not be identified separately and should be treated like any other savings – which would imply that merger savings should be taken into account only when they arise and then be subject to the five year rolling mechanism.

Treatment of pension costs

Retrospection: We agree that retrospection is not normally a desirable feature of regulation. However, it is questionable whether the funding of current pension scheme deficits represents the retrospective adjustment of past costs, since the market movements that are the root cause of these deficits are very recent. In any event, we agree with Ofgem's conclusion that the lack of clarity regarding the past treatment of pension costs within the price controls means that it is now necessary to create a clear starting position.

Protected Persons Regulations: We understand that Ofgem is not attempting to affect the legal rights and duties of employers or pension scheme members. However, that is not the point at issue. The point is that distributors (and public electricity suppliers before them) had legal obligations which meant that they could never achieve the competitive level of costs referred to in Ofgem's June 2003 paper. It would therefore be wrong for Ofgem to label costs arising from a legal obligation and disallow their recovery.

Past underfunding: Ofgem stated in its June and July 2003 price control papers that: "Increases or decreases in the future costs of providing accrued benefits resulting from under or over funding in prior periods will need to be considered on a case by case basis". In our view, however, delving into previous price control proposals to purportedly extract the assumed level of company contributions to pension schemes is impracticable, as Ofgem has not typically made available the detailed assumptions underlying its past price control calculations.

In addition, Ofgem is incorrect to say that previous price controls were based on efficient accounting charges. This is because operating cost allowances were set at the last review in relation to the standardised controllable costs of the frontier companies (i.e. Eastern). This dimension of the price control process has largely (and irrevocably) divorced the price control for an individual company from any detailed identifiable assumptions about the operating costs of that company.

We urge Ofgem to ensure that its detailed methodology statement (which it says will be issued next month) recognises that there is no justification in principle, and substantial difficulty in practice, in trying to base the next set of price controls on an analysis of actual past pension contributions, relative to (estimated) price control assumptions, before the current period.

Regulated/unregulated split: We look forward to Ofgem's detailed proposals to be brought forward next month. We believe that the element of a distributor's contributions going forward which is properly attributable to it for the purpose of eliminating any funding deficit and which therefore should be taken into account in setting the price control is that amount which is necessary to cover:

- All the accrued and future pension liabilities for those distribution business employees of the distributor who at 1 October 2001 were assigned under the relevant Transfer Scheme to it, together with

- All of the accrued pension liabilities in respect of all the former employees of that distributor's PES predecessor (and of the predecessors of that PES) up to 30 September 2001.

Ofgem's argument at paragraph 7.22 of its update paper – that competing non-ex-PES suppliers “also have substantial legacy pension liabilities (including the majority of those with the largest market shares)” – is unpersuasive (after all, market share is unrelated to the need not to distort the market), and we are surprised that Ofgem makes it. Companies which inherited pension liabilities at privatisation received some offsetting endowments at the time, but rely upon a secure revenue stream to cover some of their obligations. On the other hand, companies which took over supply businesses after privatisation had the opportunity to negotiate an appropriate balance of pension liabilities, asset endowments, and purchase price. If Ofgem wants to switch pension liabilities away from the distributor, it will need to arrange a similar transfer of assets – and then allow distributors to recover the costs of this transfer from customers.

Ofgem also tries to imply that allowing the distributors to recover the historic PES obligations would amount to a subsidy, but does not define how this would arise. Clearly, allowing cost recovery of historic obligations via the regulated business does not harm competition in any way, nor would it constitute a subsidy to the supply business.

Ofgem states that companies who sold supply businesses would have “retained the full benefit” if the value of the pension liabilities had decreased (paragraph 7.23). This reasoning is flawed. Once the distributors had sold off their supply businesses, they would have expected their future revenues to cover their costs, including the cost of historic pension liabilities, whether those costs rose or fell. Indeed, the allowances set by Ofgem in 1999 seem to have taken advantage of reductions at the time (because Eastern, the company that set the frontier, was enjoying reduced contributions).

Enhanced benefits: We note Ofgem's line of argument that, in benefiting from out-performance of price control cost assumptions, companies are expected to take account of the non-recurring costs of achieving recurring savings. Ofgem's analysis, however, is incomplete because:

- Ofgem, through its practice of establishing cost frontiers and catch-up targets, requires distributors to reduce costs without any out-performance benefit for shareholders. It would not be correct to deny recovery of the costs of achieving such savings.
- Customers have benefited from cost reductions that, according to Ofgem's reasoning, may not have occurred had the full non-recurring costs been understood at the time. If cost recovery is denied, then prices should be returned to the position that would have pertained had the saving not been achieved in the first place.

We agree that the price control position regarding redundancy costs has not been clearly expressed in past reviews. We therefore look forward to seeing Ofgem's detailed proposals as part of its methodology statement.

December paper: We believe that Ofgem's forthcoming detailed methodology statement should:

- Stress that the maintenance of good long-term incentives requires Ofgem to define "reasonable" or "reasonably efficient" costs by reference to specific legal obligations bearing on distributors, and
- Explain all disallowances by reference to specific distributor past actions or behaviour which were inefficient (and which would therefore mean that customers should not bear all the future costs of pension contributions).

Note: The views set out in the above section on the treatment of pension costs are further elaborated in three papers submitted recently to Ofgem on behalf of all distributors for discussion with Ofgem on 25 November. We fully endorse and concur with the contents of those papers.

Initial RIA for distributed generation

We believe that it is important that Ofgem should undertake a regulatory impact assessment in respect of distributed generation and the proposals that are being considered. At this stage, we have already provided information to Ofgem in the distributed generation business plan questionnaires, but we will also want to give further support to Ofgem for the RIA work.

EDF Energy
November 2003